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INTEREST-SENSITIVE PRODUCTS IN A "STABLE" RATE ENVIRONMENT

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- "Stable" refers to an investment environment in which interest rates are neither volatile nor running at historically high rates. Discussion will include:
  - Methods of arriving at current rates
  - Current regulatory restraints on illustrative rates. Should these be changed or extended?
  - Illustrations of vanishing premium products
  - Advantages of deferring taxes on inside build-up
  - Trends toward emphasis on marketing of financial services
  - Buy term and invest the difference

MR. ROBERT L. WHITNEY: I will briefly describe the topics to be covered. We will be talking about most of the topics with emphasis on current interest rates and regulatory requirements. We will not be specifically addressing the C-3 risk nor the related question of matching of assets and liabilities. Those topics are well covered elsewhere. It is an oversimplification to say we will be covering everything else there is to say about interest rates, but I believe you will find that the panel has a wide range of topics to cover.

I will be the first panelist and will address "buy term and invest the difference." My position is executive vice president and actuary at A. L. Williams Corporation.

PANEL DISCUSSION

The next speaker will be Gregory J. Carney, vice president and chief actuary of Variable Annuity and Life Insurance Company. Greg's extensive experience in annuities -- fixed and variable -- make him well qualified to address those products.

The penultimate speaker will be Mark A. Tullis, consulting actuary at Tillinghast-TPF&C. Prior to becoming a consultant, Mark was at Liberty Life Insurance Company. He is highly experienced in universal life, variable life, and variable universal life and will emphasize those topics.

Our last speaker is Bernard Wolzenski, a partner at Ironwood Financial and Consulting Services. I wonder how many of us have considered getting into sales . . . however fleetingly? Ben is somewhat unique in that he is an FSA and devoting himself primarily to sales activity. He is our wind-up speaker because of the field perspective he will bring to our discussion. He also will cover vanishing premium products.

In planning my comments as a panelist, my initial thought was that everyone in the audience will have heard of A.L. Williams. Then I was reminded of a surprising fact that, not infrequently, I meet actuaries who have not heard of A.L. Williams. Perhaps this does not apply to actuaries who are attending this particular session. In any event, to my noninsurance friends, I describe A.L. Williams as a tremendous marketing organization that is achieving record-breaking sales of term life insurance and mutual funds. The commissions from these combined products are generally significantly less than provided by whole life, variable life, or universal life products. This is the overview I provide my noninsurance friends. Some of you might provide a less charitable description.

To be as successful as A. L. Williams has been in the sale of "buy term and invest the difference," you must have a good term product. Obviously, it helps to have Art Williams as a motivator and general leader of your marketing activity. But all of us in management at A. L. Williams are convinced that we would not be talking about production of $80 billion or more of individual life insurance sales in 1986 if we had not made four major product improvements in four years.

Our current product, which accounts for over 95% of our business, is "term to 90" with the initial term period being twenty years through issue age 50. Premiums are level during each premium period. The absence of the front-end load is new for us. Through these product improvements, our average face amount per policy issued has tripled and our twenty-year cost payment index has roughly been cut in half.

How have we been able to triple our average face amount and cut our twenty-year cost index in half? With field motivation and training (which includes strong emphasis on programming to meet needs), extremely low expenses, favorable mortality, and stable persistency. Our experience is not confidential, but it does not appear appropriate to take time to go into details at this particular session. I would be glad to answer questions later or provide information after the session to anyone who would like to know more about our term products and/or experience.

Moving on to mutual funds, A. L. Williams' agents do invest the difference. Just what the difference is has become a little fuzzy. The percentage of insurance applications which are not replacement has increased to 50%. And the other 50% often involve a greater yearly outlay. Regardless of how the difference is defined or treated, the sale of mutual funds is impressive.

Through September 30, 1986, $936 million of mutual fund contributions were made. This will increase to about $1,300 million by year end. Both numbers represent about 2.6 times the amount of term insurance premium which is being paid. Stock analysts who follow the insurance industry and have heard the story from the establishment that "buy term and invest the difference" is okay as a concept (but nobody ever invests the difference), are quite impressed with our mutual fund sales numbers.

Our standard proposal continues to assume utilization of a flexible premium annuity rider. However, very little new money is going into the annuity rider. Some agents occasionally use the track record of our biggest mutual fund seller. Of course, they must be registered to do this. A. L. Williams has over 20,000 registered representatives and this number is growing about 3% each and every month. More general usage of actual track records is being studied.

It is too early to know whether we will conclude this to be both desirable and feasible.

Any illustration of mutual funds, whether it involves track records or not, must comply with the National Association of Securities Dealers (NASD) requirements. The NASD manual on Investment Company Securities states: "While it is not possible to prevent every reader of a communication which illustrated investment results from attributing unwarranted predictive value to the data, adequate consideration of certain basic principles can reduce this risk."

These basic principles include:

1. Investment performance should be related to investment objectives over meaningful periods.

2. Time periods illustrated should be appropriate and fair.

3. Investment results cannot be predicted or projected and historical illustrations should reflect this.

4. Charts and tables should be clear.

5. Summary results should be adequate and supporting data is needed.

6. All relevant charges and expenses should be included.

The NASD manual provides a paragraph of explanation for each of the above six principles. The manual should be consulted for details.

IRAs are important in the competitive picture. Mutual funds qualify for use as an IRA whereas whole life, universal life and variable life do not. On the other hand, the advantage of those products' cash values being taxed only to the extent they exceed premium payments, which implicitly or explicitly include the cost of insurance, is not available under "buy term and invest the difference." Also, the availability of deducting the $2,000 annual contribution in an IRA from current taxable income is being curtailed under tax reform. This applies only to those (1) covered under a pension plan; and (2) with incomes above certain limits. These limits are not expected to be too troublesome to A. L. Williams' markets.

The Life Insurance Marketing Research Association (LIMRA) recently reported in a research study that young people with middle incomes, who are not especially interested in risk, are nevertheless attracted to variable life. We've known that for quite some time about mutual funds. Accordingly, A. L. Williams believes that, on balance, mutual funds and IRAs will continue to be an important force. However, as a contingency, we are taking a look at variable annuities.

Regardless of what we do about variable annuities, A. L. Williams is totally committed to "buy term and invest the difference." Our reasons, in brief, include:

1. A highly competitive term product is available.

2. The severability between protection and savings is considered important.

3. There is greater flexibility before and after retirement, especially after retirement. It is my understanding that our agents stress the flexibility after retirement considerably in point of sales discussions.

4. It is easy for us to be critical of short term yields under whole life and universal life products.

5. Long term projected yields under whole life, etc., while a definite improvement over short term projected yields, do not match long term mutual fund performance. Further, we note increasing concerns and references to propping up unrealistic current interest rates on universal life policies.

6. Our commitment to the "buy term and invest the difference" strategy was strengthened by the nature of the counterattacks directed at A. L. Williams during its formative years.

7. We do not need whole life type commissions.

These reasons are important to us. Still, we do not expect a landslide switch within the industry to the concept of "buy term and invest the difference." Some of the reasons are obvious. Also, at least two members of the panel will be speaking to the health that exists and can be expected to exist in the future with regard to whole life, universal life, and variable life type products.

MR. GREGORY J. CARNEY: I am going to discuss annuities and cover the topics on the agenda as they relate to annuity products. When I looked at the agenda, it seemed to me that primarily product development topics would be covered. I thought I would start today off with my favorite product development saying: "state-of-the-art product development consists of waiting for others to move and putting on bells and whistles." We have come a long way since that quote was applicable.

Our topic today is dealing with a stable interest rate environment. When Bob called me to talk about this, I was extremely confused. I spent a lot of time trying to figure out what a stable environment was and finally concluded that it was probably nonsense, because if there is one thing that we can count on, it is change, and it is the changing environment that has probably brought us all here today.

It is the perception of people that is stable. The general perception is that interest rates in the future are going to be at whatever level they happen to be today. This seems to me to be very true of many of the investment folks we deal with. With that perspective, I can talk about setting rates or products in a stable environment.

How do you set credited interest rates? The question, as it relates to annuities, must be addressed first from your interest-crediting philosophy: Are you going to be on a new money basis or a portfolio basis? That decision is very important. If you are on a new money basis, you will be more competitive as interest rates rise. If you are on a portfolio basis, you will be more competitive as interest rates decline. If the environment is truly stable, it will not matter.

We should not talk about setting interest rates without talking about asset-liability management. I was very pleased to see the asset-liability topic finally expressed appropriately on the agenda. I get very upset at the terminology "asset-liability matching." In my opinion, you cannot match . . . it can't be done. Semantically, I was very pleased to see the terminology "asset-liability management." That is really what we are trying to do. We are trying to manage the assets, manage the liabilities, and assess the risk that is associated with that. My perception is that you really need a ladder of maturities providing the appropriate cash flows.

In setting credited rates, we can use what I call a "spread management" basis. We take our gross yield, subtract the appropriate spread that we need for profit, and come up with the net rate. It seems to me that this process is doomed to failure because of competition. If we are going to participate in the competitive environment, we cannot currently get the margins we need to support the products. I do not know who sets the competition's interest rates, but it's not the actuaries. Also, it's not the presidents of the companies, if they look at the bottom line. Somebody out there is setting the interest rates and making our lives very difficult.

The new money methodology of establishing interest rates will tend to be extremely competitive and extremely aggressive in today's environment. You definitely are not going to make your margins, so your strategy is either to reduce your rate on the older business or, in the future, reduce your rate on this business as it gets older. On the portfolio method, you are viewing your total liabilities and your total assets for your existing portfolio. Again, you are extremely concerned because of competition and competitive pressures in terms of getting that gross overall yield that you need for profits. None of this paints a very good picture. What we really need to do, if we are going to work on an interest spread basis (I personally don't think that's correct), is increase that gross spread to cover the risks that are associated with quality, with changes in the yield curve, and with changes in anticipated cash flows.

The next topic on the agenda is current regulatory restraints on illustrated rates. There is a great deal of discussion going on as to current proposals and some of the projections being made. This is an area that, as actuaries, we have to be extremely concerned about. The NAIC really doesn't have any restraints on what you can illustrate, but the model regulation as it relates to annuities requires you to show, as part of your proposals, the yields to accumulated value and to cash surrender value at various durations. That's really intended for contracts that, in effect, have a permanent surrender charge or contracts that work on a tiered interest rate basis, so the client will know what his actual yield would be if he should surrender ten years out, compared to the high current rate that is being advertised.

Utah has developed an interesting approach. As part of its policy approval routine, they require the actuary to certify that, if there is no change in the interest rate environment, the projected rate of interest is the rate the company will pay. For example, if you are on a new money basis, and your current rate is 10%, and you know that you can't afford 10% and your intention is to drop it down to 7%, you can only project at 7% in Utah.

For variable products, the projection must be for a minimum of ten years of prior experience. If you go beyond ten years, you should do it in five-year increments. If your fund doesn't have ten years' worth of data, then it must show inception to date. You can't just show a period that you happen to like in terms of performance.

There are two rules to look for governing variable product illustrations -- The Investment Company Act and the Fair Practices Act. The Securities and Exchange Commission (SEC) rule 156 says that investment results cannot be projected. The other area to look at is the NASD Rules of Fair Practice. One of the things it says is that any advertisement that you use must be filed with the NASD within ten days of its first use.

The Investment Company Institute was asked by the SEC to develop some guidelines on the yields shown on bond funds, etc. For your information, those were filed on September 19, 1986. Comments are due back by December. They are going to try to standardize the proposals and methods for reporting returns, to require risk disclosure, and to eliminate the NASD filing requirements.

My next topic is the advantage of deferring tax on the inside build-up. This is the primary benefit of annuities. Under the new tax law, life insurance and annuities remain legitimate tax shelters. The annuities really provide an IRA type of deferral for the nonqualified funds. That's really what makes annuities competitive right now. Regarding putting nonqualified funds into the IRAs, when the money is distributed, it comes out on a blend basis. Anybody that has nonqualified money they could add into an IRA is much better off putting it into an annuity product. I don't know how you could talk about advantages of deferring tax on the inside build-up without talking about single premium life. Single premium life avoids the penalty tax that the annuities have. It can have a zero cost loan provision that allows you to withdraw funds without incurring an immediate tax.

The last topic on the agenda is the trends to emphasize on marketing financial services. Bob talked about "buy term and invest the difference." The company I used to work for had a slogan that was "buy term and invest" -- they wanted you to put in more than the difference. That was the way we started the reverse-load single premium deferred annuities (SPDAs). (I like that terminology much better than no-load.) The back-end surrender charge SPDAs were the first move to competitive interest rate products, and that led to the unbundling of universal life. All of this, I think, is leading to a distribution system of total financial planning and fee-for-service consultants. The goal that we might have as we head down this path is to get the discretionary dollars. I think the way we do that is to get closer to the money chain to attract those dollars. We have to attack it where the money is earned, where it is deposited, and where it is spent. There are a number of companies that are making these moves now.

MR. MARK A. TULLIS: Before I get started I can't help but note that I was quite impressed by your remark in the introduction, Bob, that you have 20,000 registered representatives selling mutual funds -- particularly, in light of the fact that one of the common excuses companies give for not going into variable life and variable annuity products is the difficulty of registering their sales forces.

I will discuss universal life, variable life, and single premium whole life and how these products appear in a stable rate environment. I will also spend some time touching on tax and other advantages of these products in such an environment.

As the program explains, a stable interest rate environment is one in which interest rates are neither volatile nor running at historical high levels. I agree with Greg that, since you really cannot predict the future, people's perception of the investment environment is important. A key question you can ask with respect to these products is: How does the fact that the general public perceives us as being in a stable rate environment (one with fairly low rates) affect the sales of these products? That is, are these products less attractive in what may be a lower rate today than what we had a few years ago?

So that there's no confusion, let me define what I mean by each of these products. Universal life is an interest-sensitive, regular premium product where the interest rate credited is either determined completely at the carrier's discretion or by means of an an external formula, but it is not contractually tied to an underlying set of investments. This definition takes in not only typical universal life products but also excess interest whole life and fixed premium universal life products.

Variable life is any kind of life insurance where the cash value is directly tied, on a contractual basis, to the performance of an underlying set of invested assets. This definition includes traditional fixed premium variable life as well as variable universal and single premium variable life.

Single premium whole life is the general account product which has become popular in recent years as a high performance alternative to single premium deferred annuities. It achieves this high performance because of the preferred tax treatment that is given to the accumulation value at death as well as the preferred treatment given to policy loans and withdrawals.

INTEREST-SENSITIVE PRODUCTS IN A "STABLE" RATE ENVIRONMENT

An important factor that determines the market appeal of these interest-sensitive products in any rate environment is the interest rate that can be used by the insurance company in its sales illustrations. Because these interest-sensitive products are primarily sold from computerized proposals that illustrate accumulated cash values based upon hypothetical future interest rates, the interest rates permitted and generally used in the illustration have an enormous impact on how the product is perceived by prospective purchasers.

Restrictions placed on the rates that might be used are particularly important in what we have defined as a stable rate environment, that is, the lower interest rate environment of 1986; particularly, since the current dividend scales used to illustrate competing participating products are virtually unrestricted.

For variable life products, the SEC essentially requires that at least three investment rates must be shown. The maximum rate generally cannot exceed 12% and the minimum rate illustrated must be 0%. Note that the 12% and the 0% are gross rates, thus any policy load expressed as a reduction in the investment earnings rate (such as a mortality and expense risk charge) must be netted out, resulting in net rates in the neighborhood of 11% to -1%. Most companies in their sales illustration actually choose rates like 0, 6 and 12%. However, a number of companies have decided to illustrate at maximum rates less than the 12% range.

A few years ago, when universal life policies were crediting net current interest rates in the 12% range, this restriction on variable policies may have been considered a disadvantage. However, with current universal life interest rates averaging below 10%, this SEC requirement has actually turned into a possible advantage for the variable products because the maximum net interest rate illustrated will typically exceed the current rate for competing universal life policies.

It is interesting to note that an exception to this SEC restriction is that if the prospective purchaser individually requests a specific proposal to be run at an interest rate higher than 12%, the company is allowed to produce such a proposal. There are all sorts of stories floating around about this. One is that one life company, shortly after it introduced its variable product, had a number of specific requests from a group of its agents for rates in the 20% range. Evidently, these agents' policyholders were real curious as to what the policy looked like at 20%. If this sort of thing gets out of hand, the company runs the risk of having the SEC clamping down, maybe not only on the individual company but on the industry as a whole.

At one time, a significant number of universal life policies had credited interest rates which were tied to external indices such as the 90-day T-bill rate. However, with changes in the tax code, indexed products have generally gone out of favor. Now almost all universal life policies have credited interest rates which are determined at the discretion of the company.

How is this rate determined? Most companies are really just starting to look at utilizing some sort of sophisticated scenario testing of interest-crediting strategies. Clearly, in my opinion, this is going to be the wave of the future, used to guide companies not only in interest rate crediting but investment strategies. Currently, most companies have a less sophisticated technique, where they have a committee within the company composed of, possibly, an actuary and somebody on the investment committee or somebody from the marketing department, and they spend some time looking at short term cash flow and investment projections. Then the marketing guy throws all that out and sets the rate based on what the competition is doing.

Tillinghast performs a monthly analytical study of universal life policies and one of the key items we look at on a monthly basis is the interest rate credited to universal life policies. We can track the mean universal life credited interest rate versus the AAA corporate bond rate and the one-year treasury note rate over the past twelve months. There is a clear trend -- the mean universal life credited interest rate tends not to be as downward responsive as typically recognized interest rate indicators. A year ago, the mean universal life credited rate, which at that time was receiving complaints of being too high, was at least lower than the AAA bond rate. Now it is higher. Interest rates have dropped close to 250 basis points in the past twelve months but the mean universal life rate has dropped only about 100 basis points. Why is there a discrepancy? There are a number of reasons why universal life credited rates have not tracked general interest rates very well.

First, the universal life market has become very competitive, and companies are afraid of being significantly lower than their competition in this area. The current interest rate is easily understood and is really the most visible sign of competition that people see. Second, a number of companies probably justify the discrepancy because the amount of money being credited with the high rate is currently very small. In the future, as the funds tend to accumulate for these products, there may be more reluctance to give in to competitiveness and lag the market on interest rates. Third, a number of companies have probably invested in what might be considered fairly long term investments for this type of product. With the recent decline in interest rates, their average portfolio yields may be significantly higher than the new money rates.

Single premium whole life, which also has discretionary interest rate credits, typically has current interest rates much more in line with the current new money rates than universal life. This is primarily because the cash for this product is received upfront. The current rate has a more significant effect on profitability in the early durations. Also, companies are more reluctant to allow current rates to be subsidized by higher portfolio rates. It is interesting to note that, typically, single premium life products are designed so that there are no mortality charges on a current basis. Effectively, the cost of the pure insurance is being paid for, at least in theory, by dropping the credited rate 60 to 100 basis points so if you normally credit 9%, you may end up crediting something in the 8 to 8.4% range. There is definitely competitive pressure on these products. I'm familiar with a company that just introduced a single premium whole life product with zero current mortality charges and is actually crediting a higher rate currently than it is crediting on its SPDA.

Let's look at some of the tax and other advantages these products have, compared with their primary competitors. Along with Greg, I feel that single premium whole life mainly competes with the SPDA.

Some advantages of the single premium whole life are (1) no federal income tax is payable on the death proceeds of the life policy, whereas the accumulated value of the annuity is subject to income tax at death; and (2) money can be obtained from the single premium whole life product through policy loans on a tax deferred basis, with taxes deferred indefinitely as long as the contract remains in force and doesn't lapse.

The main advantage of the SPDA is that it may qualify as an IRA, subject to the new tax law's restrictions on IRAs. Also, since there is no pure insurance necessary, you can avoid the 60 to 100 basis point charge for the cost of insurance that is deducted from the interest credited to the single premium whole life policy.

Comparing a single premium variable life product with a mutual fund, the life policy has the advantage that taxes are deferred until the proceeds are received, whereas under the new tax law, mutual funds may incur taxes, even on capital gains, on an annual basis. Also, as with any life product, federal income tax is not payable on death proceeds. Finally, with the life policy, policy loans provide access to cash without current taxation and without any taxation as long as the policy is kept in force until death.

On the other hand, mutual funds typically have more fund options than variable products, giving more of a choice of how to invest your money, and again, since it is not necessary to purchase pure insurance, cost of insurance rates and mortality risk deductions can be avoided, which may result in better net fund growth.

Comparing universal life to term plus some kind of unspecified investment such as an annuity or a mutual fund, the universal life contract has the advantage that no income tax is payable at death. Policy loans provide access to cash without current taxation and without any taxation as long as the contract remains in force until death. The taxes on the universal life policy are usually deferred until proceeds are received at lapse.

The fund value of the universal life policy is available to pay cost of insurance on a tax efficient basis, because you can access that money without incurring tax on the build-up; whereas, if you, say, put the money in an annuity and took money out of the annuity to pay for the insurance, you would incur taxes on your annuity distributions. As Bob mentioned, since your cost basis is considered to be the entire premium paid, essentially the cost of the insurance is included in the cost basis in the life contract.

The term plus investment vehicle, as Bob indicated, may qualify as an IRA depending on the investment and the limitations in the new tax law, and more investment alternatives are available if the investment is made at the owner's discretion.

I feel that differences between universal life and participating life contracts are more form than substance. From a mathematical point of view, almost anything that can be done with a universal life policy can be done with a participating policy and vice versa, so that most of the differences between these contracts tend to be cosmetic, with primary differences being tied to how discretionary interest rates or dividend interest rates are determined by the company, and the regulatory requirements placed on how the products are illustrated.

This relationship between universal life and participating whole life can be used to summarize the role of these interest-sensitive products in today's stable rate environment. It is rare that one product or product type has a clear cut competitive advantage over all of its competitors. Which product has an advantage depends on who is doing the comparison and how the comparison is performed. I have seen numerous situations where companies have taken inferior products and achieved satisfactory sales results through superior marketing. I believe these interest-sensitive products will continue to thrive and that in any interest environment, the successful companies will continue to be those who are able to exploit their marketing advantages to the fullest.

MR. BERNARD WOLZENSKI: As Bob mentioned at the outset, I will be primarily covering vanishing premium products and, as I do so, adding a limited field perspective on other topics.

A vanishing premium life insurance illustration is one in which payments may not be needed to maintain the coverage after some point, based on factors which are not guaranteed. My partner and I have a saying that insurance is like underwear -- nobody really enjoys paying for it, but most people realize they need it. It is this prospect of limited payments which makes vanishing premiums one of the most palatable ways for individuals to buy life insurance.

There are numerous types of vanishing premium illustrations and multiple products which can be used. Let's consider seven types, review the differences between them, and, finally, consider each from the viewpoint of the life company, the policyholder, and the agent.

1. Par whole life, vanish by surrender of paid-up additions. This is the classic and original vanishing premium, where dividends are used to purchase paid-up additions to that point where, combined with future dividends, all premiums can be paid from dividend values.

2. Par whole life, vanish by policy loans and surrender of paid-up additions. This is not minimum deposit, and there is no deduction of interest assumed, so this is unaffected by the pending tax law change. I have seen only a couple companies illustrate this way. It is just an illustration technique to move up the vanish point. In this case, policy loans are used to accelerate the vanish. In other words, instead of paying seven years' premiums, you may only pay five years' premiums. Then, both premiums and loan repayments, because the loan is eventually repaid, are made by surrendering additions and using future dividends.

3. Par whole life, vanish by special nonforfeiture option. I am only sure of one company that offers this. Under this special nonforfeiture option, a combination of participating paid-up insurance and one-year term insurance is purchased to maintain a level death benefit. This is the paid-up analog of what we used to call enhanced protection contracts, where whole life is the base plan, and you have one-year term and paid-up additions.

4. Interest-crediting or interest-sensitive whole life.

5. Universal life. In both 4 and 5, a vanish point occurs when the cash value plus interest credits less mortality charges, based on current

factors, are such that no further premium payments are needed to carry the contract to maturity.

6. Variable life or variable universal life.

7. Term insurance and separate investments. You may not think of 6 and 7 in terms of vanishing premium illustrations but, by the definition of a limited number of payments required to maintain an amount of insurance, you can think of these as different types of vanishing premium illustrations. The description of vanishing premium for these two products is analogous to that of interest-sensitive and universal life, except that it is total investment performance, not just interest-credited, which is taken into account. And, there are additional restrictions on how these illustrations can be done. In some cases, the agent has to make them in two steps because he can't make them in one step.

To recap, we have seven kinds of vanishing premium products or illustrations: three-par whole life, interest-sensitive whole life, universal life, variable life or variable universal life, and term insurance and investments.

Let's consider three elements of product differences: nature of investment performance, other nonguaranteed elements, and product construction.

All the products depend on investment performance to achieve the premium vanish. If it is contractually paid up at the guaranteed interest rate, we are not calling that vanishing premium -- that is a traditional limited payment contract. Whole life and universal life contain a guarantee of principal and interest, and excess interest depends on results in the company's general account or a special investment strategy pursued through the general account. It is that excess interest which makes the vanishing premium illustration work. The actual interest rate credited may depend on the company's portfolio rate, a new money rate, competitive conditions, or it may be linked to an outside index, usually based on bond or treasury yields.

Variable life, variable universal life, and separate investments have only those guarantees, if any, which are inherent in the underlying investments.

There is no direct guarantee of the principal -- it's the interest rate plus the principal that are at risk, not just the interest rate. So that is investment performance and how investment performance works in different products.

Nonguaranteed elements, other than investment performance, include mortality charges or term premiums, expense charges, and the variable loan interest rate. (Don't forget one of our vanish methods included making loans and, in this case, the loan interest rate matters.) Let's consider these mortality or other nonguaranteed elements product-by-product.

For par policies, both mortality and expense costs may vary and would be reflected in dividends. In addition, in the case of vanishing premium illustrations in which policy loans are used, the loan rate, or the relationship between the loan rate and the dividend interest rate, is an additional variable. For nonpar contracts, term and/or expense charges may be guaranteed. However, unless this guarantee is combined with an indexing of the interest-crediting rate, the insurer has the ability to make adjustments in these charges through the interest rate declared.

The third area of product differences is product construction. Par whole life is a single bundled product; interest-sensitive whole life is partially unbundled; universal life is, in general, completely unbundled but still a single product, and with term insurance and a separate investment, you have unbundling to the point of distinct products.

My second recap is that we have seven types of vanishing premiums. We also have investment performance, other nonguaranteed elements, and product construction as additional variables in thinking about vanishing premium illustrations. All this general background has a point, which is, to consider this from the viewpoint of the insurer, the buyer, and the agent.

To the insurer, considerations are competitiveness, persistency, and administration. In the area of competitiveness, there are two predominant considerations. The first is that products which use up every last dollar of value to achieve their vanish have a built-in advantage (in requiring minimum premiums to vanish) over those which do not. This means that interest-sensitive products have an advantage over straight par whole life because of the "tail" on whole life. I call the tail all the excess of illustrated dividends over premiums that starts occurring somewhere from 15 to 20 years after the policy is issued. It is not an insignificant item because that dividend can get up to two, three, or four times the premium if you go out enough durations.

Also, the principle of using every last dollar means that flexible premium products have an inherent advantage because exactly the number of premium dollars needed to achieve a given vanish year can be used. Why pay $1,002 for five years when you can pay $1,001 for five years? But don't pay $1,000 for five years because then the policy lapses at age 87. On the other hand, fixed premium products vanish in the lowest number of integral years needed to produce sufficient values. One company I have seen uses a fraction of the last year's premium paid and a fraction out of paid-up additions in its illustrations, which is simply another degree of complexity in its illustrations.

The second competitive consideration for an insurer is that investment return dominates the results. For a male, nonsmoker, issue age 35, the even tradeoffs are something like 0.5% of interest for a 30% difference in mortality, or a 45% difference in the amount of first-year commissions paid. It thus becomes possible for any company to make great strides in competitive illustrations by using separate accounts, or separate investment products, where a higher investment return is somehow more believable. It is an interesting phenomenon. If you say the company needs to credit 10% for the life of the contract to make the vanish point work, an individual may be a little skeptical when he knows that rates on CDs are down in the 6% range. However, if you say it's a separate investment, then it's a little more believable.

A second consideration for the insurer after competitiveness is persistency. Can we sell it. Can we keep it? The first persistency consideration is that the most aggressive illustrations are also the least likely to be met and therefore run the greatest persistency risk. The other persistency consideration is that the most complex illustrations are the least likely to be understood and therefore also run a greater persistency risk. A key consideration for any company in choosing between competitiveness and persistency, where on the spectrum they want to fall, is the nature of its field force and policyholders. You can easily make a product look more competitive at the risk of having your margins cut very close or a lot of complexity in your illustration. But, do you want to do that? The question a company has to ask itself is: How likely are other agents to re-examine what a policyholder has purchased? You know how that will turn out if the policyholder doesn't understand what he bought in the first place. How likely is it for the same agent to move the policyholder to another company, if the first company disappoints both the agent and the policyholder by not meeting the projected vanish point?

A third area for life company consideration is administration, which is simply the answer to the question: Can we effectively administer what we have illustrated? The general answer is simply that added degrees of complexity and technique do come at a price -- the price is added administrative cost.

Now let's turn to the buyer. If you can, and I realize this is very difficult for actuaries, imagine yourself as a buyer without an insurance background. Think about all the different variables which determine whether a vanishing premium proposal will perform as illustrated: investment return and the kind it is -- a portfolio rate or a new money rate; a rate set by competition; indexed, nonguaranteed mortality charges; different degrees of cushion in the vanish point; etc.

Ask yourself a few questions. First, would you have understood the foregoing discussion? Second, would you have been willing to listen to it? And yet, if you are not made aware of the caveats that go with the vanishing premium illustration of what you have purchased at the outset, would you be happy with the agent and the company when you find out about them later on? Finally, even if you understood some of this at the point of the initial sale, would you be able to recall any of this from the footnotes on a sales proposal? If your answer to any of these questions is yes, you may have been in the home office too long.

How does the agent view all this? It varies of course, but, even when working with more sophisticated clients, having something that the agent understands and can explain simply and briefly is of extreme importance. Competitive products are sometimes important, but it is more in the mind of the agent than it is in the mind of the buyer.

When you talk about agents, you have to say something about commissions. With regard to vanishing premium products, the key element is that some commissions continue to be paid after the premium vanishes if service by the agent is still expected, and if continuation of the policy by the policyholder with the same company is still expected. With regard to first-year commissions, more and more agents have the ability to set their own commissions by the use of riders or various products, but not just choosing term insurance and investments or a lower load product. Even within the same company, there may be different kinds of universal life with different loads. There may be whole life products with paid-up additions or other type riders that let the agent lower his compensation to almost as low as he wants.

Bob said the term insurance and investment package let the agent get significantly less commissions and presumably pass those values on to the buyer. My perspective is that with what I have to operate with, I can lower my commissions to the same level -- if I choose to do that and if I feel that's how much I need to be compensated for what I'm doing.

Greg, you mentioned that there was a trend toward fee-for-service consultants. I have a mild disagreement. I am very skeptical about how much success there is going to be on a pure fee-for-service basis. Financial planning is something that we do, and we think it is a great adjunct to both life insurance and investment sales and helping people. But it's like getting somebody to go to a lawyer or an accountant; they would rather have something that's packaged in a lot of cases.

Mark, your comment was that most of these interest-sensitive products are sold from computer illustrations. There may be a disclosure requirement but my comment would be most of the actual sales are done with a wave of the computer illustrations: "but now I am going to tell you what it really means."

MR. WHITNEY: Tell me more about the products that you would use to bring your commission levels down to the levels of term insurance and mutual funds.

MR. WOLZENSKI: At least three good-sized mutual companies have semi-unbundled traditional products where you can construct a product out of a minimum amount of whole life, something like a paid-up addition rider and one-year term purchased out of the dividends. That package in all three companies, I believe, can effectively reduce your first year commission to under 10% on a large enough case.

In the universal life area, you may be aware that companies have series of products with successively lower commissions and, in some cases, they are very close to single digit commissions. One company choosing a different approach to that has a rider on its universal life which can be used for up to 90% of the coverage which pays a very low commission rate, and while the total compensation would not be single digit, I think it would be comparable to single digit commissions on a side fund plus a normal commission on the term insurance product because the total premium is low enough.

MR. WHITNEY: I must acknowledge that I was not aware of the first product that you mentioned, with the special dividend option. I am, of course, aware of different series of universal policies; but, in my own defense, I would say it is my impression, without having any hard facts, that most of the universal life policies are sold at the higher commission.

MR. WOLZENSKI: I absolutely agree with you. Most of our sales are at the full commission level. It's just that the question I was trying to bring up was that we have the ability, if we want to, to bring our commissions down to a level that we feel is appropriate for what service we have done or that we have to because of the situation.

MR. WHITNEY: If.what is happening in Florida takes over in other states and prevails, this would be interesting.

MR. WILLIAM CARROLL: When pointing out the advantages of single premium life over deferred annuities, it is said that one of the advantages is that, in New York state, Regulation 126, requiring the special actuarial opinion, does not apply to single premium whole life. Also, the commissioner's annuity reserve valuation method does not apply to single premium whole life. For the information of the people in the audience who may not know, there is a task force in New York state which has begun work on a bill, with the hope of introducing it during the 1987 legislative year, that would change those two statements. That is, the valuation actuary concept would be extended to include single premium whole life and the commissioner would be given the authority to establish the reserve method with the understanding that the method he established might well be something like the commissioner's annuity reserve valuation method.

MR. LARRY R. ROBINSON: One of the concerns I have and our management has expressed on occasion, is that the disillusionment on disappearing products can be deferred for an extended period of time. I've been with our company long enough -- some thirty years -- to have seen disillusionment on policies sold in the 1930s or 1940s when dividend scales had been cut by most of the mutual companies. Products that were to have paid up in eighteen years ended up paying up in twenty or twenty-two. By then, it was a little too late.

The design of most of the disappearing products, as I understand it, are not subject to the discipline of change. For example, if policies are sold with a five-year disappear, and the true disappear year is eight or ten -- is the policyholder notified or does he find out in year twenty-six that the premiums will have to be resumed? I'd be interested in any comments you might have on that.

MR. WOLZENSKI: What happens, I think, is entirely a function of what service the agent does and what the company does. You are right, especially on universal life. You can think you have a five-year vanish if that's what you bought three years ago when the credited rate was 12%, and only pay five premiums without service or without another agent to tell you otherwise. You may find out after twenty-six years that suddenly the term has run out and now instead of five premiums, you have triple the premium and pay for the rest of your life.

Different products work different ways. With traditional products, you get earlier warning signals than with universal life. I come back to having the agent add enough margin to the illustration or add enough discussion to the sales presentation to let the policyholder know that it is conditional. My rhetorical questions were ones meant to indicate that it's a tough job to get the peoples' attention long enough for them to understand what they are buying and the conditions. It's not that the effort doesn't have to be made, especially now that agents have an ability to choose premium levels on products, to choose levels and to choose vanish years that have some margin of safety and can sustain lower interest rates than are currently being credited.

MR. WHITNEY: I have sort of a frivolous comment on vanishing premiums. I have three small whole life policies purchased a number of years ago. They aren't really vanishing premiums. I've been able to make the cost of insurance vanish by using dividends to buy paid-up additions and then taking a maximum loan every year. The increase in loan plus the federal income tax savings, at least currently, more than cover the premium and loan interest. I think the mutual company is making me a small cash contribution each year, and I still get some protection.

MR. RODNEY C. WILTON: I was curious about the Utah law as it applies to a portfolio contract. I can see, with the new money contract, what it means when you say you have to illustrate based on what happens if current conditions continue. If your portfolio rates are 11% and current new money rates are 8%, what does that do to what you can illustrate?

MR. CARNEY: I don't know. The Utah law is based on policy approval and is part of the policy approval process. I would assume that when you are filing the policy and they are asking you questions, your response is going to have to be whatever your best judgment is in terms of the rates. If rates continue at 8% forever, obviously, your portfolio rate is bound to come down. I would probably have difficulty supporting an 11% continued if projection rates stayed at 8% forever.

MR. LARRY WARREN: There are three comments I would like to make. First, to the extent that the rebating becomes legitimate in other states, I think there is one consequence that we can anticipate. That is, we will see a worsening of the persistency due to the fact that the premium slope is obviously going to be increased from year one to year two. The dramatic reduction in first-year premium will then tend to simulate the select and ultimate term insurance product. Whether we are talking about a whole life product or a term insurance product, the fact that, in effect, the policyholder pays or can pay a substantially lower first-year premium means a greater likelihood of the policy not persisting in year two.

Second, I think a rule of thumb was given that 0.5% differential on the interest spread in a product may roughly be equivalent to a 45% additional first-year commission -- if I understood that correctly. My studies have indicated that on a level premium paying product, the rule of thumb would be a 1% spread in interest margins is equivalent for roughly 30 or 40% difference in first-year commission. I would think that the 0.5% differential on a vanishing premium product would account for no more than a 15% difference in first-year commission.

The third comment is, if one looks at the typical market for the single premium whole life policy, it's no secret that it is directed at the older age market and, in general, there is a certain amount of liberalized underwriting. Putting that all together, I think the effective mortality cost is dramatically greater than 60 to 100 basis points.

MR. WOLZENSKI: Relating interest spreads to other factors, in every case you pick, you get a different result. The numbers I gave were for an actual case and actual product using a vanishing premium. I will clarify that when I talked about a 45% difference in first-year commissions, I meant 45% of what would normally be the commission, not 45% of premium. I did run a fairly young age and a nonsmoker, so that may account for my coming up with a smaller tradeoff than you would choose.

MR. TULLIS: I agree that persistency might become worse if antirebating becomes widespread. It is interesting to speculate whether a correlary to that might not be that commissions would tend to be levelized. Companies might not be willing to pay the upfront commission they are currently paying.

Regarding the cost of mortality on single premium life, *Best's Review* did a comparison of these products, and one thing that varies widely is the amount of the face amount that you can purchase for a given amount of premium, dependent upon which test you use to qualify it under Section 7702 and what the guaranteed mortality charges are in the contract.

The net amount at risk is dependent upon the contract. That's one thing that is going to vary quite a bit by company. Some companies may have big cash value corridors that effectively cause them to have greater amounts of coverage initially. Some companies may have lower amounts of coverage early on. The Best's comparison shows what you can buy for $25,000 of premium, and it varies quite a bit among the companies in the comparison.

MR. WARREN: I think the comment on the single premium whole life product was the fact that the net rate presumably was somewhere between 60 to 100 basis points less than what a gross rate would have been.

MR. TULLIS: You made the comment you thought it was greater. I'm saying the amount of coverage for any given premium is subject to a lot of variation. If you have a contract where you purchase a lot of coverage, maybe 60 to 100 is not adequate.

MR. JOHN O. MONTGOMERY: The NAIC at the present time is considering a regulation regarding a yield index for interest-sensitive products. Mr. Walt Miller is chairman of our advisory committee on that, and maybe he would like to say a few words about it.

MR. WALTER N. MILLER: The now world-famous Yield Index Advisory Committee has been in business for a couple years. We submitted a report for last December's NAIC meeting where we stated, trying to make it as clear as we possibly could, the purpose and the charge to this committee is not, repeat not, to say whether we think there should or should not be a mandated yield index regulation. The charge to this committee is, if there should be a yield index regulation, what it should look like, what formula should be used, what background rules should be adopted, to what area it should apply, and so on.

Our report was accepted without a lot of comments last December, and we were asked to go on and construct a proposed model regulation, which is what we are trying to do now. As I told John the other night, it's going to be sort of a photo finish as to whether we can get this done in time for formal submission to this December's NAIC meeting.

Our last December's report is a matter of public record, and mostly what we are doing is try to codify that. I would comment that one thing that has come up consistently in our committee's deliberation this year, and we meet pretty often, is the fact that many of us are saying, "Does it really matter much what formula you use for an index when you have significant questions about the credibility of the data -- the illustrative values being fed into the formula? Isn't that what is really asked from the standpoint of coming up with the next advance in the cost comparison and disclosure area that will be a real benefit to consumers?"

MR. MONTGOMERY: I would point out that when the NAIC does do this, it will apply to any situation where interest is prominent in the illustrations.

MR. MICHAEL P. HEALY: We don't have single premium whole life because we are a conservative company. We think it has many of the problems that single premium deferred annuities had. I want to attack single premium life this year, while I still can before my company comes out with it.

I don't think enough concern has been expressed, over the tax advantages of life insurance itself being leveraged too much in the single premium marketplace. I'm concerned that these are being marketed as investment vehicles, as tax shelters in an age when tax shelters, as a class, are under attack. The federal government is faced with a large deficit, and we know that it is going to start scrambling for sources of revenue in the next couple years. My chief concern is that the tax advantages of life insurance might come under attack. As money goes into single premium life, especially in the volume that it at one time did with single premium deferred annuities, it's bound to come under attack.

MR. CARNEY: I agree. The primary concern I have is that single premium life, because of the marketing of the zero cost loan as a means of taking out the tax-free inside buildup, could cost the industry an awful lot.

The second concern I have with single premium life is that this is the hot new product because the stockbrokers can't sell SPDAs anymore, because of activities that have occurred in the past. We were going to sell single premium life, but it's an SPDA. The only problem now is that, when you talk about policyholders moving from one company to another, they can only do so if they are in good health. We have a mortality spiral being built in, that potentially could cause trouble.

The third aspect I have major concerns with is the guarantee associations. We are having, in my opinion, a blurring between life and annuity products. Single premium life is an obvious example; to some degree, universal life is as well. I think that the guarantee associations should have two accounts -- a health account and a life account -- and that the life account should include all annuities.

MR. WHITNEY: Ben, at the end of his remarks, raised a question as to whether a noninsurance person would understand his presentation. Well, I'm going to put that to the test. My prospective son-in-law recently sent me 10 sales illustrations. I couldn't figure out why the agent had bothered him with 10 illustrations, 6 of which are vanishing premium -- it seemed to me that it caused too much confusion. Anyway, the key point I want to make is that I think that my prospective son-in-law may understand Ben's dissertation a lot better than he did mine -- at least I'm going to give it a try.